The Failure to Pay Penalty Is Not Always Calculated or Assessed Correctly

March 2003

Reference Number: 2003-10-077

DEPARTMENT OF THE TREASURY

WASHINGTON, D.C. 20220

INSPECTOR GENERAL
for TAX
ADMINISTRATION

March 28, 2003

MEMORANDUM FOR COMMISSIONER, SMALL BUSINESS/SELF-EMPLOYED DIVISION

Gordon C. Milbourn III

FROM: Gordon C. Milbourn III
Acting Deputy Inspector General for Audit

SUBJECT: Final Audit Report – The Failure to Pay Penalty Is Not Always Calculated or Assessed Correctly (Audit # 200110048)

This report presents the results of our review assessing the adequacy of the Internal Revenue Service's (IRS) efforts to effectively implement the provisions of Internal Revenue Code (I.R.C.) § 6651(h) (2001) relative to the Failure to Pay (FTP) penalty for individuals who timely file a tax return and receive an installment agreement.

In summary, the IRS is not always reducing the FTP penalty to 0.25 percent in the month the installment agreement is approved, as intended by the Congress. IRS computer programming correctly reduces the FTP penalty to 0.25 percent but not until the month after the installment agreement is approved. In addition, the IRS is not reducing the FTP penalty to 0.25 percent if the taxpayer obtains an installment agreement within 10 days after the final notice of intent to levy is issued.

We also determined that the IRS did not always correctly apply I.R.C. § 6651 when calculating the FTP penalty in four different situations. Specifically, the IRS did not always:

- Suspend the FTP penalty for cases in which the taxpayer received bankruptcy protection.
- Start the FTP penalty at the proper time after a tax assessment was made.
- Consistently apply overpayments from other tax years when calculating the FTP penalty.

- Manually compute the FTP penalties correctly on cases involving a Substitute for Return (SFR).[1]

We recommended that the Small Business/Self-Employed (SB/SE) Division request that IRS computer programming be revised to ensure that the FTP penalty is reduced to 0.25 percent the first month that a taxpayer enters into an installment agreement or when an installment agreement is approved within 10 days of issuing the final notice of intent to levy. We also recommended that the SB/SE Division identify the applicable taxpayer accounts that did not receive the reduced FTP, as of the effective date of January 1, 2000, and abate/refund the FTP penalty as appropriate.

In addition, we recommended that the SB/SE Division request that IRS computer programming be corrected to ensure that the FTP penalty is computed correctly for tax accounts in bankruptcy status, with credits being applied from other tax periods, or with additional tax assessments. We also recommended that the SB/SE Division issue a memorandum to employees re-emphasizing the procedures for manually calculating the FTP penalty when an SFR is prepared.

Management's Response: The Commissioner, SB/SE Division, agreed with the recommendations presented in the report. Although an initial analysis by Modernization, Information Technology and Security (MITS) Services indicated that system limitations might preclude programming changes for some of the report recommendations, SB/SE Division management agreed to submit systems change requests to address the recommendations. SB/SE Division management stated that they would work with MITS Services to explore alternative solutions if any systems change requests cannot be accomplished. SB/SE Division management will also ensure tax examiners are trained on manually calculating penalties and interest.

Management's complete response to the draft report is included as Appendix V.

Copies of this report are also being sent to the IRS managers who are affected by the report recommendations. Please contact me at (202) 622-6510 if you have questions or Daniel R. Devlin, Assistant Inspector General for Audit (Headquarters Operations and Exempt Organizations Programs), at (202) 622-8500.

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[1] An SFR is a tax return prepared by the IRS showing the tax due for an individual taxpayer who fails to file a return.

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Background

Internal Revenue Code (I.R.C.) § 6651 (2001) includes penalties for taxpayers who do not pay their tax liability when it is due. A Failure to Pay (FTP) penalty under I.R.C. § 6651(a)(2) (2001) is imposed when any tax due on a return is not paid by the due date of the return. The FTP penalty is also imposed under I.R.C. § 6651(a)(3) (2001) on any (subsequently assessed) tax that is not shown on a return as required. The penalty is not imposed if the taxpayer shows that the failure to pay was due to reasonable cause and not due to willful neglect. The FTP penalty is calculated at 0.5 percent of the unpaid tax for each month that payment is overdue, until a maximum penalty of 25 percent of the tax due is reached.

The Internal Revenue Service (IRS) Restructuring and Reform Act of 1998 (RRA 98)[1] added I.R.C. § 6651(h), effective January 1, 2000, which provides that the FTP penalty under subsections 6651(a)(2) and (a)(3) will be reduced from 0.5 percent to 0.25 percent for individuals who timely file returns (taking extensions into account) and enter into installment agreements.

The Congress passed the legislation to reduce the FTP penalty for individual taxpayers with installment agreements because it believed that it was inappropriate to apply the full FTP penalty to taxpayers that are paying their tax liability through an installment agreement.[2]

The reduced FTP penalty (0.25 percent) applies to an individual’s taxes including income, employment, and excise tax liabilities. We limited our audit work to individual income tax liabilities because our planning indicated that the new provision predominantly affected individual income tax liabilities.

Our audit work was conducted at the New Carrollton, Maryland, IRS Office with the Small Business/Self-Employed (SB/SE) Division’s Compliance function and Modernization, Information Technology and Security

[1] IRS Restructuring and Reform Act of 1998 (RRA 98), Pub. L. No. 105-206, 112 Stat. 685 (codified as amended in scattered sections of 2 U.S.C., 5 U.S.C., 5 U.S.C. app., 16 U.S.C., 19 U.S.C., 22 U.S.C., 23 U.S.C., 26 U.S.C., 31 U.S.C., 38 U.S.C., and 49 U.S.C.).
[2] H.R. Rep. No. 364, 105th Cong., 1st Sess. 81; S. Rep. No. 174, 105th Cong., 2nd Sess. 63.

(MITS) Services officials during the period September 2001 through October 2002. The audit was conducted in accordance with *Government Auditing Standards*, with the exception of the report contents reporting standard. Specifically, we determined that IRS programming did not calculate the FTP penalty correctly when taxpayer accounts had an adjustment to refundable credits, such as reversals of the Earned Income Tax Credit and the withholding credit. However, we are not including this issue in our report and are not making a recommendation to correct this problem because it is being reviewed by another Treasury Inspector General for Tax Administration audit team.[3] Detailed information on our audit objective, scope, and methodology is presented in Appendix I. Major contributors to this report are listed in Appendix II.

The Failure to Pay Penalty May Not Be Reduced as Appropriate When Taxpayers Receive Installment Agreements

The IRS was not always reducing the FTP penalty to 0.25 percent in the month the installment agreement was approved, as intended by the Congress. We identified two situations where this occurred. In one situation, the IRS' computer program correctly reduced the FTP penalty to 0.25 percent, but not until the month after the installment agreement was approved. In the other situation, the IRS was not reducing the FTP penalty to 0.25 percent if the taxpayer obtained an installment agreement within 10 days after the final notice of intent to levy was issued. As a result, taxpayers in 123 of our sample cases may have paid more in FTP penalties than the Congress intended. For our audit period, we estimate that 1.4 million taxpayer accounts were over assessed as much as $11.3 million in additional FTP penalties because the FTP was not reduced to 0.25 percent when an installment agreement was approved.

The IRS should reduce the FTP penalty in the first month that taxpayers enter into installment agreements

The IRS did not calculate the FTP penalty at the reduced rate in the first month the installment agreement was approved in 111 cases. Instead, IRS programming reduced the FTP penalty starting the monthly period after the installment agreement was approved. This results in

[3] *Suspension of Interest and Penalties for Tax Credits,* Audit Number 200210043.

taxpayers being over assessed FTP penalties for 1 month. For example, if the FTP penalty started accruing from April 15th and the IRS approved an installment agreement with the taxpayer on April 27th, the IRS does not reduce the FTP penalty from 0.5 percent to 0.25 percent until May 15th. We believe taxpayers are entitled to the reduced rate starting April 15th.

The RRA 98 added I.R.C. § 6651(h), which provides that the failure to pay penalty is reduced from 0.5 percent to 0.25 percent starting with the first month the installment agreement is in effect. IRS personnel responsible for coordinating FTP penalty issues informed us that they did not consider an installment agreement to be "in effect" until the beginning of the next monthly period after the installment agreement was approved.

However, Treas. Reg. § 301.6159–1(b)(3) provides that an installment agreement is "effective" when it is approved by an authorized employee of the IRS. Final Treasury Regulations provide interpretations of the I.R.C. and have the same authoritative weight as the I.R.C.

The IRS did not reduce the FTP penalty to 0.25 percent when an installment agreement was approved within 10 days of a final levy notice being issued to a taxpayer

I.R.C. § 6651(d) (2001) states that the FTP penalty is increased from 0.5 percent to 1 percent if the IRS has issued a Final Notice of Intent to Levy[4] or a notice of demand for immediate payment. The IRS is required to wait 10 days after the notice of intent to levy is issued before increasing the FTP penalty. Accordingly, if a taxpayer pays the tax due during this 10-day period, the penalty will not be increased to 1 percent because the taxpayer has paid his or her liability in full. Based on the IRS' interpretation of the law, the IRS increases the FTP penalty to 1 percent at the beginning of the next monthly period following the 10-day waiting period. We believe if a taxpayer enters into an installment agreement during this 10-day waiting period, the taxpayer is entitled to a reduction in the FTP penalty to

[4] The IRS is mandated by law to inform the taxpayer that he or she has 30 days to pay the tax liability in full before the IRS can levy the taxpayer's property to collect overdue taxes.

0.25 percent, in accordance with I.R.C. § 6651(h). In 12 of the cases reviewed, the IRS issued a final notice of intent to levy and increased the FTP penalty from 0.5 percent to 1 percent, even though the IRS approved an installment agreement during the 10-day statutory waiting period.

Recommendations

We recommend that the SB/SE Division's Compliance function management:

1. Submit a Request for Information Services (RIS) to revise IRS computer programming to ensure that the FTP penalty rate is reduced to 0.25 percent the first month that a taxpayer enters into an installment agreement.

Management's Response: Although an initial analysis by MITS Services indicated that system limitations might preclude the recommended programming change, SB/SE Division management will submit a systems change request. SB/SE Division management will work with MITS Services to explore alternative solutions if a systems change cannot be accomplished.

2. Submit a RIS to revise IRS computer programming to ensure that the FTP penalty rate is reduced to 0.25 percent if an installment agreement is approved within 10 days of a final levy notice being issued to a taxpayer.

Management's Response: SB/SE Division management will submit a systems change request to ensure the FTP penalty is calculated as required.

3. Identify taxpayer accounts, effective as of January 1, 2000, in which the FTP penalty was not reduced to 0.25 percent in the first month the taxpayer entered into an installment agreement or when an installment agreement was approved within 10 days of issuing the final notice of intent to levy, and abate/refund the FTP penalty as appropriate.

Management's Response: Although an initial analysis by MITS Services indicated that system limitations might preclude the recommended programming change, SB/SE

Division management will submit a systems change request. SB/SE Division management will work with MITS Services and other operating divisions to explore alternative solutions if a systems change cannot be accomplished and determine the most appropriate course of action.

The Failure to Pay Penalty Is Not Always Calculated Accurately and Consistently

During the course of our review, we determined that the IRS did not always correctly apply I.R.C. § 6651 when calculating the FTP penalty in four different situations. Specifically, we identified that the IRS did not always:

- Suspend the FTP penalty for cases in which the taxpayer received bankruptcy protection.
- Start the FTP penalty at the proper time after a tax assessment was made.
- Consistently apply overpayments from other tax years when calculating the FTP penalty.
- Manually compute the FTP penalties correctly on cases involving a Substitute for Return (SFR).[5]

For our audit period, we estimate that the IRS did not calculate the FTP penalty accurately and consistently for 61,645 tax accounts. As a result, taxpayers were over assessed as much as $3 million of FTP penalties.

<u>The FTP penalty was not always suspended for cases in bankruptcy proceedings</u>

We identified three cases where the FTP penalty was not calculated correctly on the IRS' Integrated Data Retrieval System (IDRS)[6] for tax accounts in bankruptcy. In general, the FTP penalty should be suspended for accounts in bankruptcy. IRS officials stated that the IDRS does not consistently suspend or restart FTP calculations when there are multiple bankruptcy indicators or other actions that change the FTP percentage rate on a tax account. IRS programmers were aware of this problem and stated that it

[5] An SFR is a tax return prepared by the IRS showing the tax due for an individual taxpayer who fails to file a return.
[6] The IDRS is the IRS' computer system capable of retrieving or updating stored information; it works in conjunction with a taxpayer's account records.

has not been resolved due to insufficient resources and other priority work.

The FTP penalty started too early in some cases with additional tax assessments less than $100,000

We identified five cases where the FTP penalty was started too early, which could result in an over assessment of the FTP penalty. In these cases, the FTP penalty should have started 21 days after the date of the additional tax assessment. However, the FTP penalty started 10 days after the date of the assessment because of IRS computer programming limitations. I.R.C. § 6651(a)(3) requires the FTP penalty to start 21 days after the date of the notice and demand for payment of tax involving assessments less than $100,000. The I.R.C. also states that if the tax liability equals or exceeds $100,000, the FTP penalty should start 10 business days after the date of the notice and demand. However, IRS computer programming does not always distinguish whether the additional assessment amount is over the $100,000 threshold.

IRS programming did not consistently apply overpayments (credits) from other tax years with respect to the FTP penalty calculation

We identified two cases where the IRS' computer systems (Master File[7] and IDRS) did not consistently calculate the FTP penalty because each system applied credits to the balance due at different times. As a result, the FTP penalty may not be assessed correctly and taxpayers could receive incorrect information from the IRS regarding how much penalty is owed. I.R.C. § 6651 requires that the FTP penalty be calculated based on the balance due, less the amount paid, each month. Responsible officials informed us that they were aware that the credits were not being applied in the same way but had not obtained a formal opinion from IRS Counsel.

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[7] The Master File is the IRS' database that stores various types of taxpayer account information, including individual, business, and employee plans and exempt organizations data.

Manually calculated FTP penalties were not always correct

The FTP penalty can be systemically or manually calculated when an SFR is prepared. We identified four cases where the FTP penalty was manually calculated incorrectly when the SFR was prepared. In 3 of the calculations, the FTP penalty was based on 25 percent of the tax due. However, in these cases, the penalty was over assessed because the calculations did not take payments into consideration, which would have reduced the tax due and the amount of the FTP penalty. We could not determine why the FTP penalty was not calculated correctly in the one remaining case. The responsible SFR analyst stated that the FTP penalty should be based on the outstanding balance, which should be adjusted each month based on any payments made. IRS personnel responsible for manually calculating the FTP penalty have been advised to refer to the Penalty and Interest Handbook for guidance in working the manual FTP computations. This handbook contains guidelines for adjusting the outstanding balance based upon payments made by the taxpayer.

Recommendations

We recommend that the SB/SE Division's Compliance function management:

4. Submit a RIS to correct IRS computer programming to ensure that the FTP penalty is computed correctly for tax accounts in bankruptcy status.

Management's Response: SB/SE Division management will submit a systems change request to ensure the FTP penalty is computed correctly for tax accounts in bankruptcy status.

5. Submit a RIS to correct IRS computer programming so that the FTP penalty does not start until 21 days after the issuance of the notice and demand for payment of taxes when the additional tax assessment is less than $100,000, in accordance with I.R.C. § 6651(a)(3).

Management's Response: SB/SE Division management will submit a systems change request to ensure the FTP penalty does not start until 21 days after the issuance of notice and demand when the additional tax assessed is less than $100,000.

6. Request an IRS Counsel opinion to determine when credits from other tax years should be applied when calculating the FTP penalty. If applicable, submit a RIS to ensure that IRS computer systems consistently apply credits from other tax years when calculating the FTP penalty.

Management's Response: SB/SE Division management discussed this issue with IRS Counsel and will submit a systems change request to ensure IRS computer systems consistently apply credits from other tax years.

7. Issue a memorandum to employees re-emphasizing the procedures for manually calculating the FTP penalty when a substitute for return is prepared.

Management's Response: SB/SE Division management advised all Automated Substitute for Return employees of the manual calculation errors identified in this report. The SB/SE Division will also ensure that all tax examiners have the appropriate training on penalty and interest issues before they make adjustments on returns.

Appendix I

Detailed Objective, Scope, and Methodology

The overall objective of this audit was to determine if the Internal Revenue Service (IRS) has effectively implemented the provisions of Internal Revenue Code (I.R.C.) § 6651(h) (2001) relative to the Failure to Pay (FTP) penalty for individuals who timely file and receive an installment agreement. To accomplish our objective, we:

I. Determined if the IRS is accurately computing the FTP penalty for individuals as prescribed by I.R.C. § 6651(h).

  A. Determined the process the IRS uses to impose the FTP penalty, specifically with regard to the reduced FTP penalty for individuals who enter into installment status to satisfy their tax liability.

  B. Determined if the IRS accurately computed the FTP penalty for tax modules where individuals had full paid their tax liability between January 1, 2000, and November 5, 2001, and had been in installment status.

    1. Obtained a Master File[1] data extract of 2,270,379 tax modules where individuals had full paid their tax liability between January 1, 2000, and November 5, 2001, and had been in installment status.

    2. Designed a stratified sample based on a 90 percent confidence level, expected error rate of 50 percent, and a precision of 7 percent (for the attribute portion). Strata 1 contained 2,267,620 tax modules where the FTP penalty was less than $5,000, strata 2 contained 2,753 tax modules where the FTP penalty was from $5,000 to $99,999, and strata 3 contained 6 tax modules where the FTP penalty was equal to or over $100,000.[2] This sampling methodology was chosen to project the number of tax modules, as well as the dollar value of modules, where the FTP penalty was calculated incorrectly. The sampling plan was reviewed by a professional statistician to ensure that it was valid.

    3. Calculated the FTP penalty for the sampled cases to determine if the penalty was accurately computed.

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[1] The IRS' database that stores various types of taxpayer account information. This database includes individual, business, and employee plans and exempt organizations data.
[2] See Appendix IV, Table 1, for sample size.

4. Projected the number of tax modules where the IRS did not reduce the FTP penalty timely using attribute sampling and the dollar value of the errors using variable sampling. The attribute projection was made using a confidence level of 90 percent, an error rate of 56.1 percent, and a precision of 6.9 percent. The variable projection was made using a confidence level of 90 percent, an average error of $5, and an estimated standard error of $1.07. The projections were reviewed by a professional statistician to ensure that they were valid.

5. Projected the number of tax modules where the IRS did not accurately and consistently calculate the FTP penalty timely using attribute sampling and the dollar value of the errors using variable sampling. The attribute projection was made using a confidence level of 90 percent, an error rate of 1.4 percent, and a precision of 1.7 percent. The variable projection was made using a confidence level of 90 percent, an average error of $1.33, and an estimated standard error of $1.21. The projections were reviewed by a professional statistician to ensure that they were valid.

C. Determined if the IRS accurately computed the FTP penalty for individuals with "terminated" installment agreements for the period January 1, 2000, through November 5, 2001.

1. Obtained a data extract from the Taxpayer Information File (TIF)[3] for 784,452 individual tax modules in which the installment agreement had been terminated at any point from January 1, 2000, through November 5, 2001, and whose tax accounts were currently in delinquency status awaiting assignment, below tolerance, assigned to the Automated Collection or the Collection Field function, closed as currently not collectible, suspended due to bankruptcy, or pending approval of an offer-in-compromise.

2. Designed an attribute sample based on a 90 percent confidence level, expected error rate of 50 percent, and a precision of 7 percent. The sample contained 139 items. This sampling methodology was chosen to project the number of tax modules where the FTP penalty was calculated incorrectly. The sampling plan was reviewed by a professional statistician to ensure that it was valid.

3. Calculated the FTP penalty for the sampled cases to determine if the penalty was accurately computed.

[3] The TIF is the major database for use within the Integrated Data Retrieval System (the IRS' computer system capable of retrieving or updating stored information; it works in conjunction with a taxpayer's account records).

4. Projected the number of tax modules where the IRS did not reduce the FTP penalty timely using attribute sampling. The projection was made using a confidence level of 90 percent, an error rate of 15.8 percent, and a precision of 5.1 percent. The projection was reviewed by a professional statistician to ensure that it was valid.

5. Projected the number of tax modules where the IRS did not accurately and consistently calculate the FTP penalty timely using attribute sampling. The attribute projection was made using a confidence level of 90 percent, an error rate of 3.6 percent, and a precision of 2.6 percent. The projection was reviewed by a professional statistician to ensure that it was valid.

II. Determined if the IRS inappropriately reduced the FTP penalty for taxpayer accounts that did not meet the provisions mandated in I.R.C. § 6651(h).

A. Obtained a data extract from the TIF for 15,869 individual tax modules with transaction code 971, action code 063 (installment agreement – 0.25 percent FTP), that were never in installment status.

1. Designed an attribute sample based on a 90 percent confidence level, expected error rate of 50 percent, and a precision of 7 percent. The sample contained 139 items. This sampling methodology was chosen to project the number of tax modules where the FTP penalty was calculated incorrectly. The sampling plan was reviewed by a professional statistician to ensure that it was valid.

2. Calculated the FTP penalty for the sampled cases to determine if the penalty was accurately computed.

3. Projected the number of tax modules where the IRS did not reduce the FTP penalty timely using attribute sampling. The projection was made using a confidence level of 90 percent, an error rate of 7.9 percent, and a precision of 3.8 percent. The projection was reviewed by a professional statistician to ensure that it was valid.

4. Projected the number of tax modules where the IRS did not accurately and consistently calculate the FTP penalty timely using attribute sampling. The attribute projection was made using a confidence level of 90 percent, an error rate of 5 percent, and a precision of 3 percent. The projection was reviewed by a professional statistician to ensure that it was valid.

Appendix II

Major Contributors to This Report

Daniel R. Devlin, Assistant Inspector General for Audit (Headquarters Operations and Exempt Organizations Programs)
Nancy Nakamura, Director
Jeffrey M. Jones, Audit Manager
Theresa M. Berube, Senior Auditor
Allen Brooks, Senior Auditor
Thomas Seidell, Senior Auditor

Appendix III

Report Distribution List

Acting Commissioner N:C
Deputy Commissioner, Small Business/Self-Employed Division S
Director, Compliance, Small Business/Self-Employed Division S:C
Chief, Information Technology Services M:I
Chief Counsel CC
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Director, Legislative Affairs CL:LA
Director, Office of Program Evaluation and Risk Analysis N:ADC:R:O
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Audit Liaisons:
    Commissioner, Small Business/Self-Employed Division S
    Director, Compliance, Small Business/Self-Employed Division S:C
    Chief, Information Technology Services M:I

Appendix IV

Outcome Measures

This appendix presents detailed information on the measurable impact that our recommended corrective actions will have on tax administration. These benefits will be incorporated into our Semiannual Report to the Congress.

Type and Value of Outcome Measure:

- Taxpayer Entitlements – Potential; 1,399,269 tax accounts[1] were over assessed $11.3 million in Failure to Pay (FTP) penalties (see page 2).

Methodology Used to Measure the Reported Benefit:

We selected three statistically valid samples and projected the results. The first sample employed an attribute and variable sampling methodology suggested by a professional statistician. The sample was stratified by the amount of FTP penalty assessed into low (assessment less than $5,000), medium (assessment from $5,000 to $99,999), and high (assessment equal to or over $100,000) strata. The sample was randomly selected from an Internal Revenue Service (IRS) Individual Master File[2] extract of taxpayer accounts that were full paid after January 1, 2000, and had an approved installment agreement. The size of the universe and sample (by strata) are shown in Table 1.

The second and third samples were attribute samples. Sample number 2 was randomly selected from an IRS Taxpayer Information File (TIF)[3] extract of individual tax modules in which the installment agreement had been terminated at any point from January 1, 2000, through November 5, 2001, and whose tax accounts were currently in delinquency status awaiting assignment, below tolerance, assigned to the Automated Collection or the Collection Field function, closed as currently not collectible, suspended due to bankruptcy, or pending approval of an offer-in-compromise. Sample number 3 was randomly selected from an IRS TIF extract of individual tax modules with transaction code 971, action code 063 (installment agreement – 0.25 percent FTP), that were never in installment agreement status. The size of the universe and sample for both samples 2 and 3 are shown in Table 1.

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[1] This number could include multiple accounts for some taxpayers.
[2] The Master File is the IRS' database that maintains transactions or records of individual tax accounts.
[3] The TIF is the major database for use within the Integrated Data Retrieval System (the IRS' computer system capable of retrieving or updating stored information; it works in conjunction with a taxpayer's account records).

Table 1

Sample	Strata	Size of Universe	Sample Size
Sample 1	Strata 1	2,267,620	139
[redacted]	Strata 2	2,753	20
[redacted]	Strata 3	6	6
Sample 2	[redacted]	784,452	139
Sample 3	[redacted]	15,869	139

Of the 165 tax modules reviewed in sample 1, we identified 90 tax modules where the FTP penalty was over assessed by $29,321 because the IRS did not always reduce the FTP penalty to 0.25 percent in the month the installment agreement was approved. In addition, we identified 22 of 139 tax modules from sample 2 and 11 of 139 tax modules from sample 3 where the FTP penalty was over assessed for the same reasons.

We estimated that the IRS may have over assessed 1,399,269 tax accounts as much as $11.3 million in additional FTP penalties. To arrive at our estimate, we:

1. Projected the results of sample 1 (by strata) to the universe and, based on a 90 percent confidence level, estimated that 1,273,855 tax accounts (plus or minus 6.9 percent precision) were over assessed $11,347,790 (plus or minus $4 million) in FTP penalties.
2. Projected the results of sample 2 to the universe and, based on a 90 percent confidence level, estimated that the FTP penalty was over assessed for 124,158 tax accounts (plus or minus 5.1 percent precision).
3. Projected the results of sample 3 to the universe and, based on a 90 percent confidence level, estimated that the FTP penalty was over assessed for 1,256 tax accounts (plus or minus 3.8 percent precision).

1,273,855 + 124,158 + 1,256 = 1,399,269

Type and Value of Outcome Measure:

- Taxpayer Entitlements – Potential; 61,645 tax accounts[4] were over assessed $3 million in FTP penalties because the IRS did not always correctly apply I.R.C. § 6651 (see page 5).

Methodology Used to Measure the Reported Benefit:

We employed the same sampling methodology to calculate this outcome measure as for the previous outcome measure.

Of the 165 tax modules reviewed in sample 1, we identified 2 tax modules where the FTP penalty was over assessed by $184 because the IRS did not always calculate the FTP penalty accurately and consistently. In addition, we identified 5 of 139 tax modules from sample 2 and 7 of 139 tax modules from sample 3 where the FTP penalty was over assessed for the same reasons.

We estimated that the IRS may have over assessed 61,645 tax accounts as much as $3 million in additional FTP penalties. To arrive at our estimate, we:

1. Projected the results of sample 1 (by strata) to the universe and, based on a 90 percent confidence level, estimated that 32,628 tax accounts (plus or minus 1.7 percent precision) were over assessed $3,008,267 (plus or minus $4.5 million) in FTP penalties.
2. Projected the results of sample 2 to the universe and, based on a 90 percent confidence level, estimated that the FTP penalty was over assessed for 28,218 tax accounts (plus or minus 2.6 percent precision).
3. Projected the results of sample 3 to the universe and, based on a 90 percent confidence level, estimated that the FTP penalty was over assessed for 799 tax accounts (plus or minus 3 percent precision).

32,628 + 28,218 + 799 = 61,645

[4] This number could include multiple accounts for some taxpayers.

Appendix V

Management's Response to the Draft Report

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

COMMISSIONER
SMALL BUSINESS/SELF-EMPLOYED DIVISION

RECEIVED
MAR 17 2003

MAR 12 2003

MEMORANDUM FOR DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: Joseph G. Kehoe
Commissioner, Small Business/Self-Employed Division

SUBJECT: Draft Audit Report – The Failure to Pay Penalty Is Not Always Calculated or Assessed Correctly (Audit # 200110048)

I reviewed your draft report and agree with your findings. As part of this audit, we worked with our Counsel to obtain clarification relative to the application of the 0.25 percent failure to file penalty (FTP) in situations where an Installment Agreement has been accepted. Our Counsel's advice concurs with your findings that .025 percent FTP should begin on the first day of the month in which the agreement posts to a taxpayer's account.

We also agree that the FTP penalty, in isolated instances, may be miscalculated when a taxpayer's account involves bankruptcy suspension, subsequent assessments, offsets, or complex manual applications. We are currently taking steps to resolve all of these issues.

With respect to the measurable benefits you identified, we agree that some over assessments have been made as a result of the miscalculations. We will continue to work with the other affected operating divisions to make the necessary changes to resolve this issue.

Our comments to your recommendations follow.

RECOMMENDATION 1
Submit a Request for Information Services (RIS) to revise IRS computer programming to ensure that the FTP penalty rate is reduced to 0.25 percent the first month that a taxpayer enters into an installment agreement.

ASSESSMENT OF CAUSE
We did not always reduce the FTP penalty to 0.25 percent in the month the installment agreement was approved.

CORRECTIVE ACTIONS
An initial analysis by Modernization, Information Technology, and Security Services (MITS) found that current system limitations may preclude us from making the programming changes necessary to initiate the 0.25 percent FTP rate during the first month the taxpayer enters into an installment agreement. We will submit a systems change request and continue to work with MITS to determine feasibility and if necessary, explore alternative solutions if a systems change cannot be accomplished.

IMPLEMENTATION DATE
January 1, 2005

RESPONSIBLE OFFICIAL
Director, Reporting Enforcement, Small Business/Self-Employed Division

CORRECTIVE ACTION MONITORING PLAN
The Program Manager, Office of Penalties and Interest, will advise the Director, Reporting Enforcement, Small Business/Self-Employed Division, of any delays in completing the corrective action.

RECOMMENDATION 2
Submit a RIS to revise IRS computer programming to ensure that the FTP penalty rate is reduced to 0.25 percent if an installment agreement is approved within 10 days of a final levy notice being issued to a taxpayer.

ASSESSMENT OF CAUSE
Our current systems do not allow the application of the 0.25 percent rate when an installment agreement is accepted during the ten-day period before the increase to the one percent rate can be applied.

CORRECTIVE ACTIONS
We will submit a systems change request and track implementation to provide the 0.25 percent FTP penalty rate for accounts with an installment agreement posting inside the ten-day period as required by Internal Revenue Code section 6651(d).

IMPLEMENTATION DATE
January 1, 2005

RESPONSIBLE OFFICIAL
Director, Reporting Enforcement, Small Business/Self-Employed Division

CORRECTIVE ACTION MONITORING PLAN
The Program Manager, Office of Penalties and Interest, will advise the

Director, Reporting Enforcement, Small Business/Self-Employed Division, of any delays in completing the corrective action.

RECOMMENDATION 3
Identify taxpayer accounts, effective as of January 1, 2000, in which the FTP penalty was not reduced to 0.25 percent in the first month the taxpayer entered into an installment agreement or when an installment agreement was approved within 10 days of issuing the final notice of intent to levy, and abate/refund the FTP penalty as appropriate.

ASSESSMENT OF CAUSE
The IRS did not always reduce the FTP penalty to 0.25 percent in the month the installment agreement was approved.

CORRECTIVE ACTIONS
An initial analysis by MITS found that current system limitations may preclude us from making the programming changes to retroactively refund/abate amounts on post January 1, 2000 installment agreement accounts that were charged an additional .25 percent FTP penalty for one month. We will submit a systems change request and continue to work with MITS to determine feasibility and, if necessary, explore alternative solutions if a systems change cannot be accomplished. We will also work with the other operating divisions to determine the most appropriate course of corrective action.

IMPLEMENTATION DATE
January 1, 2005

RESPONSIBLE OFFICIAL
Director, Reporting Enforcement, Small Business/Self-Employed Division

CORRECTIVE ACTION MONITORING PLAN
The Program Manager, Office of Penalties and Interest, will advise the Director, Reporting Enforcement, Small Business/Self-Employed Division, of any delays in completing the corrective action.

RECOMMENDATION 4
Submit a RIS to correct IRS computer programming to ensure that the FTP penalty is computed correctly for tax accounts in bankruptcy status.

ASSESSMENT OF CAUSE
The FTP penalty may be miscalculated when a taxpayer's account involves bankruptcy suspension. The TIGTA identified three cases in which we incorrectly calculated the penalty.

CORRECTIVE ACTIONS
We will submit a systems change request and track implementation to ensure the FTP penalty is computed correctly for tax accounts in bankruptcy status.

IMPLEMENTATION DATE
January 1, 2005

RESPONSIBLE OFFICIAL
Director, Reporting Enforcement, Small Business/Self-Employed Division

CORRECTIVE ACTION MONITORING PLAN
The Program Manager, Office of Penalties and Interest, will advise the Director, Reporting Enforcement, Small Business/Self-Employed Division, of any delays in completing the corrective action.

RECOMMENDATION 5
Submit a RIS to correct IRS computer programming so that the FTP penalty does not start until 21 days after the issuance of the notice and demand for payment of taxes when the additional tax assessment is less than $100,000, in accordance with I.R.C. § 6651(a)(3).

ASSESSMENT OF CAUSE
The FTP penalty is assessed too early in some cases. The TIGTA identified five cases in which we applied the FTP penalty too early.

CORRECTIVE ACTIONS
We will submit a systems change request and track implementation to ensure the FTP programming does not start until 21 days after the issuance of notice and demand when the additional tax assessed is less than $100,000.

IMPLEMENTATION DATE
January 1, 2005

RESPONSIBLE OFFICIAL
Director, Reporting Enforcement, Small Business/Self-Employed Division

CORRECTIVE ACTION MONITORING PLAN
The Program Manager, Office of Penalties and Interest, will advise the Director, Reporting Enforcement, Small Business/Self-Employed Division, of any delays in completing the corrective action.

RECOMMENDATION 6
Request an IRS Counsel opinion to determine when credits from other tax years should be applied when calculating the FTP penalty. If applicable, submit a RIS to ensure that IRS computer systems consistently apply credits from other tax years when calculating the FTP penalty.

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ASSESSMENT OF CAUSE
The TIGTA identified two cases in which our computer systems did not consistently calculate the FTP penalty because each system applied credits to the balance due at different times.

CORRECTIVE ACTIONS
We discussed this issue with Counsel. We will submit a systems change request and track implementation to ensure our computer systems consistently apply credits from other tax years.

IMPLEMENTATION DATE
January 1, 2005

RESPONSIBLE OFFICIAL
Director, Reporting Enforcement, Small Business/Self-Employed Division

CORRECTIVE ACTION MONITORING PLAN
The Program Manager, Office of Penalties and Interest, will advise the Director, Reporting Enforcement, Small Business/Self-Employed Division, of any delays in completing the corrective action.

RECOMMENDATION 7
Issue a memorandum to employees re-emphasizing the procedures for manually calculating the FTP penalty when a substitute for return is prepared.

ASSESSMENT OF CAUSE
Manually calculated FTP penalties were not always correct. The TIGTA identified four cases in which we incorrectly calculated the FTP penalty when we prepared the substitute for return.

CORRECTIVE ACTIONS
We advised all Automated Substitute for Return employees of the manual calculation errors identified in the report. We will ensure that all tax examiners have the appropriate training on penalty and interest issues before they make adjustments on returns.

IMPLEMENTATION DATE
Completed December 18, 2002

RESPONSIBLE OFFICIAL
Director, Filing Compliance, Small Business/Self-Employed Division

CORRECTIVE ACTION MONITORING PLAN
N/A